

Internal Revenue Service
memorandum

TL-N-7779-88

CC:TL:TS/WSABIN

date: OCT 6 1988

to: District Counsel, Laguna Niguel W:LN
Attn: Joseph E. Mudd

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your request for technical advice regarding the validity of the statutory notice of deficiency in this case in light of Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987).

ISSUE

Is the subject notice of deficiency valid under Scar v. Commissioner, *supra*?

CONCLUSION

The notice is not valid under Scar since it was not based upon the taxpayer's return or correct return information.

FACTS

We understand the facts to be as follows. On [REDACTED], the Laguna Niguel District Director issued a statutory notice of deficiency to [REDACTED], the petitioner. This notice asserted a deficiency for the taxable year [REDACTED] in the amount of \$[REDACTED], plus delinquency and negligence penalties. It did not state that petitioner's income tax return had been unavailable.

The deficiency resulted from two partnership adjustments. The notice disallowed a deduction attributable to "[REDACTED]" in the amount of \$[REDACTED] and a deduction attributable to "[REDACTED]" in the amount of \$[REDACTED].

There is no dispute that the petitioner did in fact claim deductions attributable to [REDACTED] and [REDACTED]. Nor is there any dispute that the Commissioner prepared the notice without having the petitioner's individual income tax return on hand, which

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return is, unfortunately, still missing. One error in the notice pertains to the amount of loss attributable to [REDACTED]. The notice disallowed a deduction of \$[REDACTED], it should only have disallowed \$[REDACTED]. The petitioner has conceded that the other adjustment is the correct amount claimed by him as a deduction attributable to the [REDACTED] partnership on his [REDACTED] return. The other error in the notice was the use on the computation page of [REDACTED] as the "taxable income per return," when the correct figure was \$[REDACTED].

The petitioner's counsel has provided you with copies of petitioner's [REDACTED] K-1s for [REDACTED] and [REDACTED] as well as copies of page 2 and Statement 1 of petitioner's [REDACTED] Form 1040. He has refused to provide you with a complete copy of the [REDACTED] Form 1040.

The agent who prepared the individual notice, Paul Siebert, (714-836-2477) states that he had both of the partnership returns and the petitioner's K-1s in his possession when he prepared the statutory notice. He also states that he had an IDRS transcript from which he incorporated the petitioner's return information to compute the deficiency.

The background of the correct adjustment, to the [REDACTED] partnership item, explains how the incorrect adjustment, to the [REDACTED] partnership item, occurred. [REDACTED] reported an ordinary loss for [REDACTED] in the amount of \$[REDACTED]. Petitioner's K-1 for [REDACTED] shows he had a [REDACTED] share in the profits and losses. The product of [REDACTED] and \$[REDACTED] is \$[REDACTED]. The K-1 also shows petitioner was credited with a "guaranteed [salary] payment" of \$[REDACTED], which Siebert offset against the pro rata loss. This yields a deduction of \$[REDACTED] which the notice disallowed and which petitioner agrees was claimed by him.

On the other hand, the [REDACTED] partnership reported an ordinary loss of \$[REDACTED]. Petitioner's K-1 for [REDACTED] shows he had a [REDACTED] interest in its profits and losses. The product of [REDACTED] and \$[REDACTED] is \$[REDACTED], the amount claimed by petitioner as a deduction. However, Siebert made an adjustment of \$[REDACTED]. This is the product of [REDACTED] (the [REDACTED] factor) and \$[REDACTED]. The most logical inference from these facts is that Siebert inadvertently used the [REDACTED] factor ([REDACTED]) when he should have used the [REDACTED] factor ([REDACTED]).

The result of these adjustments was an incorrect total adjustment to taxable income of \$[REDACTED]. The correct total adjustment should have been \$[REDACTED]. At this point Siebert added the incorrect total adjustment to the amount of "taxable income per return" as shown on the transcript. The transcript shows that the taxable income was [REDACTED]. Siebert added [REDACTED] to [REDACTED] and computed the deficiency of \$[REDACTED] based upon that sum.

The transcript was wrong. The taxable income per return was \$[REDACTED]. The transcript did correctly show this amount as the adjusted gross income, but erroneously showed [REDACTED] as taxable income. As a result, the deficiency computation was based upon the tax due on \$[REDACTED] when it should have been based upon \$[REDACTED] ([REDACTED] - [REDACTED]).

Note that this did not produce a major discrepancy in actual tax rates. The deficiency based upon taxable income of \$[REDACTED] would have been \$[REDACTED]. The rate of tax per the notice was [REDACTED]%, the correct rate would have been [REDACTED]%.

DISCUSSION

The problem here is that the error in the transcript impugns the integrity of our "return information" when it is used in lieu of the actual return. This undermines our litigating position in light of Scar and creates a hazard of litigation that cannot be risked.

As you know, in the Scar opinion the Ninth Circuit held that the "patent incorrectness" of Scar's statutory notice led it to conclude that the Commissioner had not made a "determination" of Scar's deficiency and therefore the notice was invalid and the Tax Court lacked jurisdiction.

The Tax Litigation Division described its litigating position on this issue in Litigation Guideline Memorandum, No. TL-3 (Scar LGM), dated January 15, 1988. This position is that if a statutory notice is issued in the Ninth Circuit without the benefit of a taxpayer's return, but makes the correct adjustment, makes the wrong adjustment amount, and does not employ the "plug rate," we will defend it if there is a "reasonable nexus" between the disallowed deduction and the return. The Division believes that use of return information from computer records could constitute such a nexus.

The Scar LGM expressed the Division's concern that the Ninth Circuit might have believed that the Commissioner was required to have a taxpayer's income tax return on hand before he could make a valid determination of a deficiency. See Scar, supra, fn. 6.

But recent opinions tend to belie this notion. In Campbell v. Commissioner 90 T.C. 110 (1988) (held: a notice of deficiency with the wrong computation pages attached is not invalid) the Tax Court said:

Where a notice of deficiency does not reveal on its face that the Commissioner failed to make a determination, a presumption arises that there was a

deficiency determination, Scar v. Commissioner, *supra* at 1367 note 6 and 1369 note 9. *Id.* at 113 (emphasis in original),

and,

Where the alleged notice of deficiency reveals on its face that respondent failed to make a determination, then the Ninth Circuit would require respondent to prove that he did make a determination. *Id.* at 114.

The Ninth Circuit itself has revisited Scar, albeit in a limited context. In Roat et. al v. C.I.R. 847 F.2d 1379 (9th Cir. 1988) the Court held that Scar did not require the Commissioner to prepare a return for a non-filing taxpayer before issuing the taxpayer a notice of deficiency.

The Roat opinion distinguished Scar:

Scar fits best in a line of cases addressing determinations of deficiency on their merits. These cases state that the Commissioner, to rely on the presumption that his deficiency determination was correct, must have recourse to some evidence showing a taxpayer received income from the charged activity. Compare *id.* at 1366 (Commissioner did not consider any information relating to taxpayer) with Weimerskirch v. C.I.R. 596 F.2d 358, 360 (9th Cir. 1979) (determination unsupported by any evidence is arbitrary and erroneous). *Id.* at 1382.

These cases suggest that both the Tax Court and Ninth Circuit would be receptive to an argument that Scar does not require the Commissioner to have a taxpayer's return on hand as a prerequisite for making a valid determination of a deficiency. Instead, it should be sufficient to have only "return information," compiled from IRS computer records.

If the only error here was the computation of the [REDACTED] adjustment, we would recommend defending the case. Our argument would be that the requirements of Scar were satisfied because the determination was based upon return information, and was therefore valid. The slight error in the computation could have been corrected by amending the pleadings.

However, the assumption at the bottom of such an argument is that the return information, compiled from our computer records, is accurate. Here that information proved to be inaccurate. Thus the potential exists in this case for the Ninth Circuit to amplify its Scar opinion, rather than to limit it. Such an amplification might be that since the return information kept on IRS computer records can be inaccurate, the Commissioner must

have the actual return on hand before he issues a notice of deficiency. Such a holding would create significant difficulties for the Commissioner. Therefore we recommend you concede this case.

MARLENE GROSS

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